

Speaking Notes
Pension Sustainability Commission
Friday, August 17, 2018

Chairman Steinberg and Commission Members,

Co-Chairs of the Connecticut Commission on Fiscal Stability and Economic Growth (COFSEG) Bob Patricelli and I, along with Jim Millstein of Millstein and Co., a trusted advisor to our Commission, are pleased to be invited here today to discuss the Pension Sustainability Commission's charge and to provide perspective based on our experience and the proposals we made to the governor and the legislature. Both your Commission and ours were empaneled as part of the bipartisan budget legislation passed last October. Our Commission was officially disbanded upon delivering our report in March, though Bob and I continue to actively represent the Commission's work.

We've provided some exhibits for your Commission's review, including our Commission's March 2018 final report. Please note in particular Appendix 2, Pages 72-83 - Reform the Teachers Retirement System (TRS), which we have also provided as a separate attachment. Also included is a PowerPoint presentation we often use when we're presenting the 'burning platform' findings and our proposals for structural reform, which our Commission believes would put CT back on the

road to growth and prosperity, if enacted holistically. Jim Millstein has separately provided an attachment that describes our proposal to restructure the Teachers Retirement System and lays out comparable in-kind contribution transactions.

Bob Patricelli and I will make some general comments with regard to our Commission's work, and your charge, then Jim will discuss the particulars of the proposal to restructure TRS and address other asset transfer possibilities. I want to underscore the valuable advice that Jim and Elizabeth Abrams of Millstein and Co. contributed to our deliberations on this subject.

As we noted in our report, we believe that Connecticut could benefit from evaluating the in-kind contribution of assets to its pension systems to improve their funded ratios and lower the state's annual required contributions (ARC), thereby reducing fixed costs. Managed well, this could free up funds for important investments that are being crowded out today. The state could consider in-kind contribution of land, buildings, airports, roads, healthcare facilities and other assets that the state does not need to own and which may have valuable development potential. Minutes from your July 24 meeting indicate you are thinking along these lines as well.

It's important to calculate that any asset contributions would likely be accompanied by a reduction in the actuarial discount rate to more realistic levels, and this may eat up much of the benefits of higher funded ratio related to the asset contribution. Without an accompanying reduction in benefits or higher employee contributions, don't expect much near term budget impact. The overall liabilities problem will just continue to escalate unless benefits levels are reduced.

When considering the feasibility of placing state capital assets in a trust, we ask that you consider supporting other Commission recommendations, including:

- Move the definition of retirement benefits and funding policies for state and municipal employees from collective bargaining to the legislature and local governing bodies (in 2027 or upon reopening of SEBAC).
- Reform the teachers retirement system by contributing the net lottery proceeds to improve the funded ratio and reduce annual required contributions concurrent with a move to a hybrid-defined benefit/defined contribution plan for new and unvested teachers and implementation of a risk-sharing program on investment returns and higher teacher contributions.
- Require the Comptroller to certify appropriateness of financial and investment return assumptions.

We also recommended an appointment of a private panel of experts to analyze the competitiveness of the 2017 SEBAC agreement as compared to other states and to private plans by the end of this year with the belief that contributing assets to the state's pension plans is only feasible if accompanied by benefits reductions and/or higher covered employee contributions.

So on the broad question of structured asset transfers, we think they are a 'really good idea' provided they are accompanied by plan restructuring that includes modified benefits and/or higher contributions by covered employees to pension or healthcare plans. Anything short of that reduces our collective impact to a level akin to rearranging the deck chairs on the Titanic.

Conditional asset transfers are a good way to address CT's unfunded liabilities problem. Such transactions we're suggesting will energize dormant assets by recognizing and leveraging their financial value...the market value of the assets may far exceed the value at which they are carried on the states books and that value will be unlocked in a transaction. The transfers improve the funded ratio of pension plans to which their revenue or assets are contributed, thereby making the plans more secure for their beneficiaries and lowering the plans' unfunded liabilities and related annual required contributions (ARC). Improved transparency draws attention to the assets, like real estate for example, and likely leads to more

accountability and better management of the assets, a true win/win for the plans and for state finances.

It's instructive to compare the charters of our respective Commissions so you'll understand our concerns about what you're being asked to do. Our Commission's charge was broad... "develop and recommend policies to achieve state government fiscal stability and promote economic growth and competitiveness within the state...to achieve consistently balanced and timely budgets..." while yours is very specific..."study the feasibility of placing state capital assets in a trust, maximizing those assets for the sole benefit of the state pension system." Your charge is concerning because you're expected to make recommendations that shore up state pension plans by potentially transferring assets that would otherwise serve the broader interests of the state, and there is no offsetting expectation that the plans' benefits and employee contributions will be restructured as a quid pro quo for the greater security the asset transfers afford the plan beneficiaries. So not only will satisfaction of the unfunded liabilities continue to take an ever-growing share of state revenue, crowding out crucial investments in education, workforce development, cities and transportation infrastructure, but your recommendations, unless conditioned on benefits reductions and higher employee contributions, will run the risk of co-opting the state's balance sheet, too.

In the case of our Commission, the only specific recommendation we made with regard to using revenue concessions or assets to shore up a plan was in the case of TRS. Those contributions are conditioned upon a comprehensive reform of both benefit and funding policies that would increase the funded ratio, lower the annual required contribution and enable the eventual restructuring of the amortization schedule for the bonds secured by the assets in the plan. Our proposal would also lower the plan's discount rate from 8% to a more realistic 6% which offsets much of the benefit from the revenue concessions. The key point is that the enabling legislation would not be undertaken without benefits modification.

You are probably aware that the most recent budget bill (passed in May), created a TRS reform study panel to study our proposed reforms, including the creation of a hybrid-defined benefit/defined contribution plan for new teachers with risk sharing on investment returns. We hope you'll endorse our recommendation. As you know, a key difference between the TRS and the State Employee Retirement System is that the legislature can make changes to TRS on a go-forward basis now versus the 2027 horizon for SERS (unless the SEBAC agreement is reopened). We did not recommend asset transfers to SERS at this time because there is no mechanism available to reduce benefits or elicit higher contributions...the plan would have to be voluntarily reopened for that to occur, and we hope it will. With that goal in mind, we recommended that the governor appoint a public/private task

force to examine multiple issues presented in the agreement and that based on the results the governor should seek to reopen the current SEBAC agreement on a voluntary basis. We strongly encourage you to make your recommendations for asset transfers that shore up the state pension plans conditional upon benefits modification and higher employee contributions lest your recommendations exacerbate CT's already untenable fiscal situation.

Most of the focus around the state employees' and teachers' benefits plans centers on the unfunded liabilities, which reflects the failure of governors and legislators over decades to fund commitments. It is indeed sad but true that Connecticut has one of the worst funded benefits programs in the country. But even more worrisome is the size and growth rate of the overall liability, not simply its unfunded nature. Connecticut state workers enjoy higher wages and higher benefits than both public employees in neighboring states and private sector employees, and that puts relentless upward pressure on the total liabilities.

According to a recent study, CT's massive retirement benefit liabilities have been growing at about three times the rate of economic growth over the last dozen years or so. Those ever higher liabilities increase CT's unfunded liabilities even as the rising ARCs consume an ever greater portion of state revenue. In fact, fixed expenditures now comprise 53% of the annual budget, growing at over 5% annually as compared with revenue growth closer to 1%. Every year the crowding

out of essential expenditures and investments only gets worse. So we must not only improve our funded ratio and lower the annual required contribution, we must reduce the growth rate of the liabilities themselves by renegotiating the retirement commitments, both pensions and health care benefits, made to state employees and teachers. Benefits reform is crucial to CT's fiscal health and economic viability...or Connecticut may never regain its ability to invest in the future of the three million citizens who are not beneficiaries of these benefits plans. I hope you'll bear this in mind as you consider your recommendations.

Chairman Steinberg, as you pointed out in your opening remarks of the July 24 meeting, "resolving the ongoing pension problem...is a critical step toward remedying the state's financial issues"...and "the single largest factor in this budget crisis has been the growing pension liabilities, both with the state workers and with teachers." You said that "reducing the state's liability must be the state's top priority and is something this Commission has been tasked with." You made several key points, including that we can't really cut spending enough to close the gap after eight years of cuts in discretionary spending, and raising taxes probably is not on the table, and it's unrealistic to expect we'll grow our way out of the problem in the short term, particularly if we can't achieve higher economic growth rates. You noted that a fourth way to address the fiscal condition of the state is by monetizing state-owned assets to generate money for the pensions, consistent with

your charge. I ask you to consider a fifth possibility and tie it to the fourth, which is to insist under the “feasibility” directive in your charge that contributing those assets is feasible only if there is a commensurate reduction in benefits and an increased level of covered employee contributions.

Now I will turn it over to Commission Co-chair Bob Patricelli for his comments.

Thank you.

Attachments:

1. Connecticut Commission on Fiscal Stability and Economic Growth, Final Report, March 2018
2. Connecticut Commission on Fiscal Stability and Economic Growth, Final Report, March 2018, Appendix 2, Pages 72-83—Reform the Teachers Retirement System (RTRS)
3. COFSEG Refined PowerPoint Presentation Deck (August Version)